The burdensome national debt

An individual who borrows to finance higher spending must lower future spending to repay the debt. Many assume that this applies to governments too, so that a national debt is bound to impoverish future generations. The eighth in our series of economic fallacies explains that this is often a misconception

DEBT has dreadful connotations; bankruptcy carries an awful social stigma. This has long been true. Several Dickens characters are thrown into dingy debtors' prisons. In "Hamlet", Polonius famously advises Laertes that he should "neither a borrower nor a lender be."

Taking their analogy from this distaste for individuals who go into debt, politicians routinely bemoan the national debt, which is what the government owes to its citizens (and, increasingly, to foreigners). Pitt the Younger devised a sinking fund to pay off the national debt, though the Napoleonic wars in fact left Britain massively indebted (see chart 1). President Eisenhower called the national debt "our children's inherited mortgage", and accused profligate governments of robbing their grandchildren. In the late 1980s, Margaret Thatcher briefly dreamed of repaying the national debt, though a sharp recession put paid to this idea.

Today national debts are everywhere in the news once again. Over the past 20 years, government indebtedness has risen sharply in most rich countries (see chart 2). Almost everywhere, countries are seeking to rein in budget deficits swollen by recent recessions or by lax control over public spending, especially on welfare systems. In America, Congress and president are deadlocked over the federal budget; but both are committed to balancing it by 2002. In Europe, EU member countries are struggling to meet the Maastricht treaty's fiscal criteria for monetary union, which prescribe that gross government debt should be no more than 60% of GDP, and annual budget deficits no bigger than 3%.

There are good reasons for trimming budget deficits, which can impose heavy burdens on an economy. Yet the simple conclusion that a generation which inherits a national debt of, say, 50% of GDP is bound to be better off than one which inherits a national debt of, say, 100% is confused—and often wrong. This is because the thinking that likens a national debt to an individual's debt is itself largely fallacious.

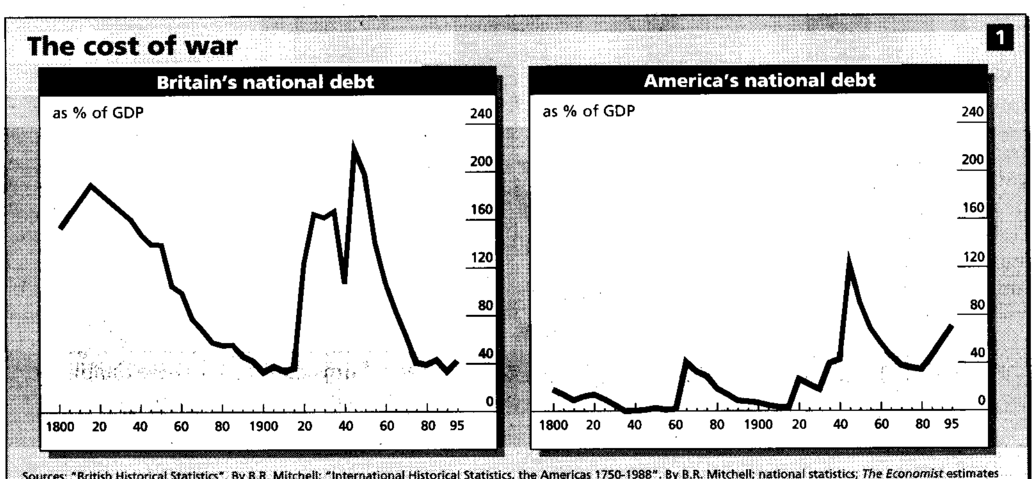
The key source of confusion lies in a failure to distinguish between cash and real resources. To an individual, this distinction matters little. When he spends borrowed cash, he raises his call on resources today; when he repays it tomorrow, he will have to cut his demand on resources back again. The effect is as if he is "borrowing" not just cash but real resources from the future.

But to the country as a whole, the distinction matters hugely. An individual can gain extra resources today, at the expense of someone else. But the country as a whole cannot. (One big caveat: this analysis assumes no loans from abroad, which can be a genuine resource transfer—and hence a direct burden on future generations. In some countries, foreigners may hold nearly a third of the national debt.) Public spending uses resources produced today, not tomorrow; it cannot, however it is financed, "borrow" resources from tomorrow, for the simple reason that those resources do not yet exist.

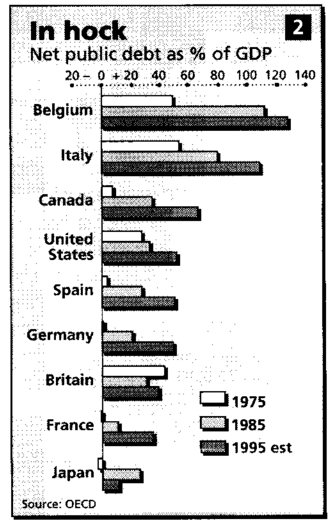
If increasing the national debt (that is, net government borrowing) does not entail a direct transfer of resources from the future to the present, does it entail any resource transfer at all? The answer is that it does; but the transfer is within the present generation, from taxpayers financing debt interest to citizens who lend to the government.

An example will help to elucidate. Suppose the total national income of a country each year is $100m. In year one, the government spends $40m, all raised through taxes, and the remaining $60m is devoted to personal consumption. In year two, the government again spends $40m, but this time finances $10m of it by borrowing through a sale of government bonds. Personal consumption remains at $60m.

In year three, the government stops borrowing; its normal spending is once again $40m. This time, however, it has to spend a further $1m in interest payments on its $10m debt (assuming a 10% interest rate). So



Sources: "British Historical Statistics". By B.R. Mitchell; "International Historical Statistics, the Americas 1750-1988". By B.R. Mitchell; national statistics; *The Economist* estimates



Source: OECD

taxation rises to $41m; the extra $1m goes to those who lent the government $10m in year two. The national debt does not lead to an inter-generational transfer of resources, from a future generation to the present; it forces an intra-generational one, from taxpayers as a whole, who service the debt, to bond-holders who receive the interest.

Interested parties

Does this mean that a government can run up as big a national debt as it likes, heedless of the future? No, for three reasons. The first is that public borrowing affects the economy today—and by extension, it will affect the economy that future generations inherit. It might, for instance, help to cause inflation; like any debtor, a government may welcome inflation for eroding the value of its debt. Getting inflation down again can impose substantial economic costs.

A second worry arises from the impact of higher taxation. Servicing a national debt will require taxes to be higher than they otherwise would be. This could damage the economy because higher taxes reduce incentives to work. Or taxes may create other distortions in capital and labour markets that damage the economy's functioning and reduce income and wealth.

Proponents of the view that a national debt is a burden on future generations do not, however, tend to rely on the potential damage from inflation or taxation for their main argument. They focus instead on the claim that government borrowing will reduce private investment—and so reduce the capital stock that ture generations inherit. That may directly lower their standard of living, compared with what it would otherwise have been.

To see how this can happen, go back to our example. This time, assume that some of the national income is saved and invested. Suppose that $10m a year is saved and used for private investment in factories, meaning that personal consumption is $50m, not $60m as before; and also assume that the new factories raise national income by $1m a year.

Now if the government finances all spending out of taxation in year one, the national income will grow in year two by $1m, to $101m. In that year, however, we assumed that the government borrowed $10m. This now absorbs the savings that would otherwise have gone into more private investment. So instead of the national income rising a further $1m to $102m, it will remain at $101m. In this way, future generations suffer a genuine loss.

Yet the size of this loss—or even whether it is a genuine loss at all—depends on two prior assumptions, which go to the heart of the debate about the burden of the national debt. The first is that all government spending is unproductive. The second is that government borrowing will always "crowd out" savings that would otherwise have been invested, while taxation will reduce consumption alone. Both assumptions are questionable.

Public spending does not all take the form of wasteful consumption. Salaries of civil servants may, indeed, fit that description. But public investment, for example in infrastructure, will often yield a direct, sometimes measurable, return. It may even yield a higher return than some private investment; in that case, even if there were crowding out of private investment, the economy could benefit in net terms. Britain, for example, might have been better off if, in the late 1980s, public investment on widening the M25 motorway had crowded out private investment in the channel tunnel.

Much public consumption also yields an implicit, if immeasurable, return: current spending on education or health care, for instance, makes workers more productive. Defence too: the return from Pitt's "investment" in winning the Napoleonic wars was incalculable, as was Churchill's in the second world war. Today's generation would not thank its predecessors if, seeking to avert a national-debt "burden", they had failed to win these wars.

As for the second assumption, public borrowing may indeed pre-empt saving and so reduce private investment; but sometimes it can reduce consumption too. Nor will the alternative, taxation, serve only to reduce consumption; some of it may reduce saving and investment as well. The balance is hard to assess—though it seems fair to assume that public borrowing is more likely than taxation to crowd out investment.

Some brave economists have, however, propounded a contrary theory, based on "Ricardian equivalence", which argues that the decision to tax or to borrow makes no real difference. According to this theory, consumers are thought to plan their consumption over time. If a government runs up a national debt, consumers know that they will have to pay higher taxes to service it in future. So they will save an equivalent amount today—meaning that the borrowing is matched by extra saving. This theory seems implausible; America's big budget deficits of the early 1980s were accompanied by a fall, not a rise in private saving. Yet in some highly indebted countries, such as Italy or Belgium, personal saving rates have, indeed, been high.

Fallacious language, too

The crucial point is this: if you want to know whether a country's national debt will burden future generations, what matters is not the size of this debt. What matters is (a) the use the money raised by the debt is put to and (b) the alternatives it displaces. A national debt that finances welfare at the expense of private investment could be a burden; one that finances a new road network or wins a war may be a boon. Economic growth makes a difference too: a fast-growing economy can happily support more borrowing than a slow-growing one.

Yet even when a national debt can disadvantage future generations by damaging the present economy or by diminishing the capital stock, is it right to call this a "burden"? Here may lie the deepest fallacy: of language, not economics. Future generations are likely to be far richer than the present one. In some ways, indeed, it is the present generation that should be thought of as bearing burdens: by investing in productive capital, it is holding down its own consumption in order to provide a generous bequest to its successors. Think of the Victorian navvies, half-starved by today's standards, who built many of the bridges and railways we use today. Can we fairly accuse that generation of "burdening" ours by bequeathing the 19th century's national debt?

A fairer way of looking at things might be to say that, in so far as a national debt reduces the productive capital that one generation hands on to its successors, it is merely trimming the size of an already massive legacy. That hardly constitutes a "burden", in any sense of the word.

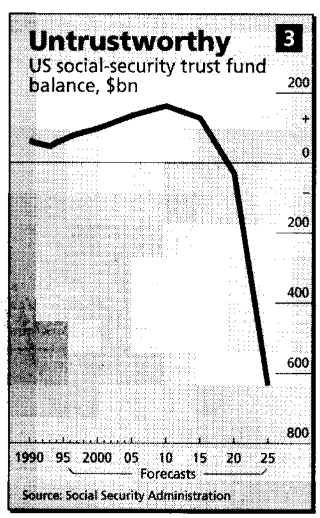
The mythical surplus

THE misconception that incurring a national debt (ie, public borrowing) is bound to impose a burden on future generations has a corollary: that running a budget surplus will always confer a benefit. Once again, the issue is not as simple as that. A surplus might, in some circumstances, help to boost economic growth. If it does not (if, for instance, it is achieved by cutting public spending on capital), it could end up being a burden.

Sometimes a "surplus" does not really exist at all. A good example is America's social-security trust fund, which finances pensions. Thanks to payroll-tax increases imposed since 1983, this is currently in surplus (see chart 3). The surplus is supposed to help pay for future pensions. But the popular notion that this somehow "deals" with the burden of those pensions is entirely wrong, for two reasons.

The most straightforward is that the surplus will not last. As the chart shows, by 2020 it will have moved into deficit. Tomorrow's taxpayers will have to finance that deficit, which arises from pension promises made today. Today's social-security surplus will not do anything to make that task easier.

But even if the surplus were to endure, it is debatable how much good it would do. For it is only a surplus on paper. It is entirely invested in Treasury debt; the overall federal budget, including the trust fund surplus, remains in deficit. When the pensions are paid and that debt is redeemed, taxes will have to be raised or fresh loans taken out—as when any Treasury debt is redeemed. In fact it makes little difference to future taxpayers whether an obligation to pay pensions is thrust on them through redeemable Treasury bonds in a trust fund—or by an unfunded contractual promise.



Untrustworthy 3
US social-security trust fund balance, $bn
Source: Social Security Administration

The most direct way to alleviate the burden of public pensions is to cut them; for instance, by reducing pension promises or by privatising the public system. And the best way to make public pensions affordable is to maximise the growth of the economy—which may or may not be helped by running a budget surplus, but is unlikely to be done by a notional trust-fund surplus.

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